

INTERMEDIATE (IPC) COURSE

STUDY MATERIAL

PAPER : 6

AUDITING AND ASSURANCE

MODULE – 1



BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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A WORD ABOUT STUDY MATERIAL

Auditing is, perhaps, one of the most practical-oriented subjects in the C.A. curriculum. This paper aims to provide working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit engagements. A good knowledge of the subject would provide a strong foundation to students while pursuing the Chartered Accountancy course. A good understanding of the theoretical concepts, particularly, in the context of auditing standards would make practical training an enriching and enjoying experience. While studying this paper, students are advised to integrate the knowledge acquired in other subjects, specifically, accounting and corporate laws in a meaningful manner. Such learning would only help a student to become a better professional.

The study material deals with the conceptual theoretical framework in detail. Its main features are as under:

- The entire syllabus has been divided into nine chapters.
- In each chapter, learning objectives have been stated. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and then can tackle the exercises.

Handbook on Auditing Pronouncements comprises of Standards on Auditing and Guidance Notes.

The Practice Manual aims to provide guidance as to the manner of writing an answer in the examination. Main features of Practice Manual are as under:

- Important Definitions have been given for quick recapitulation. Students are expected to attempt the questions and then compare it with the actual answers.
- Compilation of questions appearing during last twenty examinations.
- Exercises have been given at the end of each topic for independent practice.

This study material has been revised in view of Companies Act, 2013, Notification/Circulars issued by MCA etc. by Auditing team of experts. The changes have been inserted in the bold italics for convenience of the students.

- Attention is invited to the **Significant Additions/Modifications** made in this edition of the study material which are given on the next page.
- Please note that the changes over the previous edition have been indicated in ***bold and italics*** in the chapters.
- Diagrammatic Presentation has been made in most of Chapters for quick revision of described concept.
- Feedback form is given at the end of this study material wherein students are encouraged to give their feedback/suggestions.

In case you need any further clarification/guidance, please send your queries at Rajeev.sachdeva@icai.in and karuna.bhansali@icai.in.

SIGNIFICANT ADDITIONS/MODIFICATIONS IN 2015 EDITION OVER 2014 EDITION

Chapter No.	Chapter Name	Section/Sub Section wherein Additions / update have been done	Page Number
1	Nature of Auditing	1.3.2 Diagrammatic representation showing types of Standards issued by AASB 1.5.1 Expression of opinion 1.5.2 Errors and Frauds 1.8 Inherent Limitations of Audit 1.12 Diagrammatic representation showing relationship of Auditing with Other Disciplines	1.6 1.13 1.18 1.37 1.43
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STUDY PLAN – KEY TO EFFECTIVE LEARNING

Auditing is the heart of Chartered Accountancy Course. The intent of this paper is to understand objective and concept of auditing and gain working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit and attestation engagements. While studying this paper, students are advised to integrate the knowledge acquired in other subjects, specifically, accounting, corporate laws and taxation in a meaningful manner.

For the simplicity of the students it is suggested that the entire syllabus may be segregated into the following six parts which may be studied with the help of Chapters viz.

S. No.	Topics to be covered in each part	Reference of Chapters
Part 1	Auditing Concepts, Auditing engagement, Documentation, Audit evidence	Refer Chapter 1 & 2
Part 2	Standards on Auditing and Guidance Notes	Prescribed by ICAI in the form of list of publication Given in Handbook on Auditing Pronouncements
Part 3	Internal Control, Internal Control and Computerized Environment, Approaches to Auditing in Computerized Environment, Audit Sampling, Analytical review procedures.	Refer Chapter 3 & 4
Part 4	Audit of payments, Audit of receipts, Audit of Purchases, Audit of Sales, Audit of suppliers' ledger and the debtors' ledger, Audit of impersonal ledger, Audit of assets and liabilities.	Refer Chapter 5 & 6
Part 5	Company Audit, Audit Report	Refer Chapter 7 & 8
Part 6	Special points in audit of different types of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals, Hire-purchase and leasing companies (excluding banks, electricity companies, cooperative societies, and insurance companies), Features and basic principles of government audit, Local bodies and not-for-profit organizations, Comptroller and Auditor General and its constitutional role.	Refer Chapter 9

For the better understanding of the Standards on Auditing (SAs) given in Part 2 it may be noted that they contain two distinct sections, one, the Requirements section and, two, the Application Guidance section.

The fundamental principles of the Standard are contained in the Requirements section and represented by use of “shall”. The application and other explanatory material contained in a Standard on Auditing (SA) is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement. Further, the standard portion or principles enunciated in a Standard need not to be given in bold face.

For the remaining part of syllabus our study is divided in nine chapters viz. Nature of Auditing, Basic Concepts in Auditing, Preparation for an Audit, Internal Control, Vouching, Verification of Assets and Liabilities, The Company Audit – I, The Company Audit – II and Special Audits

Chapters from 1 to 4 are the backbone of the syllabus of Auditing and Assurance. These four chapters are basically based on Standards on Auditing. After preparing these chapters, students will be able to understand the other chapters like Vouching, Verification of Assets and Liabilities and Special Audit.

The Chapter 1 - Nature of Auditing deals with the Concept and objective of Auditing, aspects to be covered in Audit, Basic Principles Governing an Audit, Scope and Inherent Limitations of Audit, and Relationship of Auditing with other Disciplines. In this chapter, student will be able to understand the functional classification, qualities of an auditor, objectives of audit, basic principles of an audit, and different types of audit and relationship of auditing with other disciplines. The student should try to carefully understand the basic concepts and the structure of the auditing to gain the in depth knowledge of the subject. As already discussed these chapters are interlinked with Standards on Auditing. Therefore, to better understand the implication of this chapter, it is suggested to read it with SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing and SA 240, “The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements”. Instead of cramming the contents, the student should try to bring out the very idea of the chapter. This exercise will enable him to bridge the linkage for the further study.

After understanding the nature of auditing, student should try to link it with the basic concepts in auditing i.e. Chapter 2 which deals with Concept of Auditor's Independence, Audit Evidence, Concept of Materiality, Concept of True and Fair and Disclosure of Accounting Policies. Student should refer SA 500 on Audit Evidence, SA 320 on Materiality in Planning and Performing an Audit, SA 520 on Analytical Procedures and SA 505 on External Confirmations etc. alongwith this chapter. The fair understanding of the chapter has its roots in the above mentioned SAs. Hence, it is suggested that the students should understand the SAs comprehensively.

The Chapter 3 requires the students to identify the major areas for preparation for an audit for which they should refer SA 300 on Planning an Audit of Financial Statements, SA 220 on Quality Control for Audit of Financial Statements, SA 230 on Audit Documentation etc. After going through the text of these SAs the students can apprehend the chapter which deals with Auditor's Engagement, Audit Process, Techniques, Procedure, Planning, Programme, Risk,

Continuous and Final Audit, Planning and Materiality, Audit Working Papers and Obtaining Certificate from Management.

Chapter 4 is on Internal Control which deals with Concept, Environment, Inherent limitations, Accounting and Financial Control, Internal Control - Management and the Auditor, Relationship between the Assessments of Inherent and Control Risks, Internal Control and the Computerized Information System (CIS) Environment, Internal Check, Internal Audit. To comprehend this chapter the students should try to establish linkage with the SA namely 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment, SA 330 on The Auditor's Responses to Assessed Risks, SA 610 Using the Work of Internal Auditors etc. While answering to the questions of this chapter, students should be analytical and objective, without losing focus on the statement.

Vouching and verification are very important chapters. While studying these chapters, students should have knowledge of basics of an audit. Students should not stuff the steps for vouching and verification. Instead they should apply their knowledge.

Vouching is discussed in Chapter 5 which deals with Audit of cash transactions, Audit of Trading Transactions, Audit of Ledgers, Balance Sheet Audit and Analytical Procedures. The general approach to study the chapter is to examine the existing internal control system in the organisation. The appropriate ledger accounts involved, if any should also be scrutinized. Further the vouching ends with the routine checking of the receipts and payments involved and preparation of bank reconciliation statement.

Similarly the Verification of Assets and Liabilities is discussed in the Chapter 6. The main aspects covered here include Capital and Revenue Expenditure, Depreciation, Reserves, Verification of assets, Current Assets, Book-debts, Bank Balances, Cash in hand, Miscellaneous Expenditure, Verification of Liabilities, Contingent Liabilities, Events occurring after the Balance Sheet Date, Prior Period and Extraordinary Items and Changes in Accounting Policies. The basic features to study involve existence, ownership, control, rights, valuation, disclosure and presentation of the items involved. Further, student may interlink this chapter with Guidance notes, Standards on Auditing and Accounting Standards.

The Chapter 7 - The Company Audit-I deals with Qualifications and Disqualifications, Appointment, Remuneration, Removal, Powers, Duties of auditor, Ceiling on number of audits, Audit Report, Audit of Branch Office Accounts, Joint Audit, Special Audit, Cost Audit and Statutory Report. . For gaining the in depth knowledge of the subject the student should focus on the various provisions of the Companies Act, 2013, and the reporting mechanism as suggested by SAs in 700 series, and Statement on Reporting Under Section 227 (1A) of The Companies Act, 1956.

The Chapter 8 - The Company Audit-II deals with General Considerations in a Company Audit, Specific Provisions as regards Accounts in the Companies Act, 2013, Special requirements of Company Audit, Audit of Share Capital, Option on Share Capital, Shares Transfer Audit, Verification of Issue of Bonus Shares, Audit of Debentures, Audit of Dividends and Presentation of Financial Statements. Again as contemplated by the chapter 7 the requirements for understanding this chapter is same. Since the chapter deals directly with the

provisions of the Companies Act, 2013 the students should be very clear and concise in their applicational attribute. They should avoid going round and round by harping on one or two points repetitively in different ways. Instead they should reach the heart of the question and explain the major features or matters in a logical point-wise manner with sub-headings for each point and try to give a few examples in support of your reasoning.

The Chapter 9 Special Audits deals with Government Audit, Audit of Local Bodies, Audit of Non-Governmental Organizations (NGO's) and Miscellaneous Audits. Students are expected to study the procedure involved in various audits and try to establish the linkage with the knowledge gained from other disciplines like accounting for audit of partnership firms in learning the audit procedure. Further the students can relate their basic understanding while going through the other audits like audit of schools, hotels, cinemas etc. The important points in any audit include constitution, minute book, internal control, vouching of receipts and payments, verification of assets and liabilities etc. The students should try to encapsulate the procedures in various audits to command good holding of marks.

In general, students should in the first instance focus on studying Auditing concepts, procedures and techniques from the study material. The knowledge gained from meticulous study should be translated in the form of succinct notes. These notes may be accompanied by the relevant proforma and diagrams so that at the later stages of preparation, the conceptual knowledge underlying different topics may be gained within minimum time and minimum efforts without going through a number of books again.

Students should also take a keen interest in updating themselves on contemporary developments in the field of auditing by regularly referring to articles on Auditing in CA Journal, Students' monthly Journal and other relevant professional journals, publications and books.

Students may also scan through the Annual Financial Statements of Companies to analyse the notes and qualifications, if any, incorporated by the Auditors in their Audit Report.

Happy Reading and Best Wishes!

SYLLABUS

PAPER – 6: AUDITING AND ASSURANCE

(One Paper- Three hours -100 Marks)

Level of knowledge: Working Knowledge

Objective:

To understand objective and concept of auditing and gain working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit and attestation engagements.

Contents:

- 1. Auditing Concepts** — Nature and limitations of Auditing, Basic Principles governing an audit, Ethical principles and concept of Auditor's Independence, Relationship of auditing with other disciplines.
- 2. Standards on Auditing and Guidance Notes** — Overview, Standard-setting process, Role of International Auditing and Assurance Standards Board, Standards on Auditing issued by the ICAI; Guidance Note(s) on — Audit of Fixed Assets, Audit of Inventories, Audit of Investments, Audit of Debtors, Loans and Advances, Audit of Cash and Bank Balances, Audit of Miscellaneous Expenditure, Audit of Liabilities, Audit of Revenue, Audit of Expenses and provision for proposed dividends.
- 3. Auditing engagement** — Audit planning, Audit programme, Control of quality of audit work — Delegation and supervision of audit work.
- 4. Documentation** — Audit working papers, Audit files: Permanent and current audit files, Ownership and custody of working papers.
- 5. Audit evidence** — Audit procedures for obtaining evidence, Sources of evidence, Reliability of audit evidence, Methods of obtaining audit evidence — Physical verification, Documentation, Direct confirmation, Re-computation, Analytical review techniques, Representation by management, Obtaining certificate.
- 6. Internal Control** — Elements of internal control, Review and documentation, Evaluation of internal control system, Internal control questionnaire, Internal control check list, Tests of control, Application of concept of materiality and audit risk, Concept of internal audit.
- 7. Internal Control and Computerized Environment**, Approaches to Auditing in Computerised Environment.
- 8. Auditing Sampling** — Types of sampling, Test checking, Techniques of test checks.
- 9. Analytical review procedures.**

- 10. Audit of payments** — General considerations, Wages, Capital expenditure, Other payments and expenses, Petty cash payments, Bank payments, Bank reconciliation.
- 11. Audit of receipts** — General considerations, Cash sales, Receipts from debtors, Other Receipts.
- 12. Audit of Purchases** — Vouching cash and credit purchases, Forward purchases, Purchase returns, Allowance received from suppliers.
- 13. Audit of Sales** — Vouching of cash and credit sales, Goods on consignment, Sale on approval basis, Sale under hire-purchase agreement, Returnable containers, Various types of allowances given to customers, Sale returns.
- 14. Audit of suppliers' ledger and the debtors' ledger** — Self-balancing and the sectional balancing system, Total or control accounts, Confirmatory statements from credit customers and suppliers, Provision for bad and doubtful debts, Writing off of bad debts.
- 15. Audit of impersonal ledger** — Capital expenditure, deferred revenue expenditure and revenue expenditure, Outstanding expenses and income, Repairs and renewals, Distinction between reserves and provisions, Implications of change in the basis of accounting.
- 16. Audit of assets and liabilities.**
- 17. Company Audit** — Audit of Shares, Eligibility, Qualifications and Disqualifications of Auditors, Appointment of auditors, Removal of auditors, Remuneration of Auditors, Powers and duties of auditors, Branch audit, Joint audit, Reporting requirements under the Companies Act, 2013, Other Important Provisions under the Companies Act, 2013 relating to Audit and Auditors and Rules made thereunder.
- 18. Audit Report** — Qualifications, Disclaimers, Adverse opinion, Disclosures, Reports and certificates.
- 19.** Special points in audit of different types of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals, Hire-purchase and leasing companies (excluding banks, electricity companies, cooperative societies, and insurance companies).
- 20.** Features and basic principles of government audit, Local bodies and not-for-profit organizations, Comptroller and Auditor General and its constitutional role.

Note:

- (i) The provisions of the Companies Act, 1956 which are still in force would form part of the syllabus till the time their corresponding or new provisions of the Companies Act, 2013 are enforced.
- (ii) If new legislations are enacted in place of the existing legislations, the syllabus would include the corresponding provisions of such new legislations with effect from a date notified by the Institute.

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- Chapter 2 - Basic Concepts in Auditing
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MODULE – 2

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Nature of Auditing

Learning Objective

After studying this chapter, you will be able to:

- ◆ Understand the functional classification and qualities of an auditor
- ◆ Define audit and understand the objectives of audit, basic principles covering audit etc
- ◆ Distinguish between auditing and investigation
- ◆ Understand different types of audit and relationship of auditing with other disciplines.

1.1 Introduction

Historically, the word '**auditing**' has been derived from Latin word "**audire**" which means "**to hear**". In fact, such an expression conveyed the manner in which the auditing was conducted during ancient time. However, over a period of time, the manner of conducting audit has undergone revolutionary change.

According to **Dicksee**, traditionally auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purpose. But this is not the end of matter. In addition the auditor also expresses his opinion on the character of the statements of accounts prepared from the accounting records so examined as to whether they portray a true and fair picture.

Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession. No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different points of time with numerous persons and entities. The effect of all transactions has to be recorded and suitably analysed to see the results as regards the business as a whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organisation. This would be impossible without a systematic record of transactions. Financial statements are often the basis for decision making by the management and for corrective action so as to even closing down the organisation or a part of it. All this would be possible only if the statements are reliable; decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned a profit but because of wrong accounting, the annual accounts show a loss, the proprietor may take the decision to

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sell the business at a loss. Thus from the point of view of the management itself, authenticity of financial statements is essential. It is more essential for those who have invested their money in the business but cannot take part in its management, for example, shareholders in a company, such persons certainly need an assurance that the annual statements of accounts sent to them are fully reliable. It is auditing which ensures that the accounting statements are authentic. In today's economic environment, information and accountability have assumed a larger role than ever before. As a result, the independent audit of an entity's financial statements is a vital service to investors, trade payables, and other participants in economic exchange.

To correctly understand the role of auditing, you must understand the nature and purpose of the financial statements. 'Financial statements' is a set of documents which show the result of business operation during a period - how the result was achieved and the position of assets and liabilities on the given date. Progress made or success achieved during a certain period can also be readily ascertained from such a set of documents. It also makes an implied representation that it has been properly prepared, shows correct figures and the figures are set against correct description and context.

Regardless of the type of entity - whether in the public or private sector or whether for profit or not - all entities use economic resources to pursue their goals. Financial statements enable an entity's management to provide useful information about its financial position at a particular point of time and the results of its operations and its changes in financial position for a particular period of time. External financial reporting for these entities is directed toward the common interest of various users.

However, you must be clear on one point. The statements of account are viewed by different interests from different angles; consequently a statement prepared primarily for the use of the owners may not be wholly useful to interest of other users. For example, management may need more detailed information on matters considered critical by it, the investors and financial analysts are keen to see the projected image of the present state of affairs. Government would look for inadmissible items under the taxation laws, etc. Separate statements of accounting highlighting the information needed by the interested parties, other than the owners cannot be expected to be prepared in the ordinary course unless the same is specially called for. This makes the preparation of the financial statements more onerous because other users of the statement would use the information subject to such modifications and enquiry as would be considered necessary to meet their respective objective. But they must have an honest assurance that the statements have been properly compiled, prepared and presented to adhere to the requirements of owners. The auditor can accomplish this by a process of examination and appraisal.

Further, it may be noted that the management is responsible for establishing an accounting system to identify, measure, record and adequately disclose an entity's transactions and other events that affect its financial position and results of operations. Management is responsible for selecting accounting principles that appropriately reflect events that occur and for making other accounting estimates and judgments. This responsibility is not lessened by an independent audit.

1.2 Definition of Auditing

According to General Guidelines on Internal Auditing issued by the ICAI, "Auditing is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognises the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report."

The nature of the propositions which an auditor is called upon to review varies. Thus an auditor may review the financial statements of an enterprise to ascertain whether they reflect a true and fair view of its state of affairs and of its working results. In another situation, he may analyse the operations of an enterprise to appraise their cost-effectiveness and in still another, he may seek evidence to review the managerial performances in an enterprise. In yet another type of audit, the auditor may examine whether the transactions of an enterprise have been executed within the framework of certain standards of financial propriety. However, the variations in the propositions do not change the basic philosophy of auditing, though the process of collection and evaluation of evidence and that of formulating a judgment thereon may have to be suitably modified.

"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon." The person conducting this process should perform his work with knowledge of the use of the accounting statements discussed above and should take particular care to ensure that nothing contained in the statements will ordinarily mislead anybody. This he can do honestly by satisfying himself that:

- (i) the accounts have been drawn up with reference to entries in the books of account;
- (ii) the entries in the books of account are adequately supported by underlying papers and documents and by other evidence;
- (iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
- (iv) the information conveyed by the statements is clear and unambiguous;
- (v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
- (vi) the statement of accounts taken as an integrated whole, present a true and fair picture of the operational results and of the assets and liabilities.

The financial statements shall give a true and fair view of the state of affairs of the company or companies as at the end of the financial year [Section 129(1) of Companies Act, 2013].

The auditor's report shall state that—

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to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and the profit or loss and cash flow for the year and such other matters as may be prescribed [Section 143(2) of the Companies Act, 2013].

The aforesaid definition is very authoritative. It makes clear that the basic objective of auditing, *i.e.*, expression of opinion on financial statements does not change with reference to nature, size or form of an entity. The definition given above is restrictive since it covers financial information aspect only. However, the scope of auditing is not restricted to financial information only, but, today it extends to variety of non-financial areas as well. That is how various expressions like marketing audit, personnel audit, efficiency audit, production audit, etc. came into existence. Students may note that study material deals with various aspects of financial audit only unless otherwise specified.

1.3 Standards on Auditing

1.3.1 International Auditing and Assurance Standards Board: In 1977, the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale. In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world. The IFAC Board has determined that designation of the IAASB as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

The IAASB functions as an independent standard-setting body under the auspices of IFAC. The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;
- Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
- Establishing high quality standards and guidance for other related services;
- Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
- Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

The IAASB's Pronouncements: The IAASB's pronouncements govern audit, review, other assurance and related services engagements that are conducted in accordance with International Standards. They do not override the local laws or regulations that govern the audit of historical financial statements or assurance engagements on other information in a particular country required to be followed in accordance with that country's national standards. In the event that local laws or regulations differ from, or conflict with, the IAASB's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the IAASB's Standards. A professional accountant should not represent compliance with the IAASB's Standards unless the professional accountant has complied fully with all of those relevant to the engagement.

1.3.2 Auditing and Assurance Standards Board: The Institute of Chartered Accountants of India is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC. The Institute of Chartered Accountants of India constituted the Auditing Practices Committee (APC) in 1982. The main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute. While formulating the SAPs in India, the APC gives due consideration to the international auditing guidelines issued by the IAPC and then tries to integrate them to the extent possible in the light of the conditions and practices prevailing in India. While formulating the SAPs, the APC takes into consideration the applicable laws, customs, usages and business environment in India. In July, 2002, the Auditing Practices Committee has been converted into an Auditing and Assurance Standards Board (AASB) by the Council of the Institute, to be in line with the international trend. A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics. The nomenclature of SAPs had also been changed to Auditing and Assurance Standards (AASs).

A major development in the field of auditing has been the issuance of revised and /or redrafted International Standards on Auditing pursuant to the Clarity Project of IAASB. The objective of this project is to improve the clarity of International Standards on Auditing (ISAs). The IAASB aims to set high quality international auditing and assurance standards that are understandable, clear and capable of consistent application, thereby serving to enhance the quality and uniformity of practice worldwide. The Auditing and Assurance Standards Board has also laid out a strategy to match step with the IAASB Clarity Project. In the year 2007, the Board issued several revised/new Standards pursuant to the IAASB Clarity Project.

Renaming, Re-numbering and Categorisation of Auditing and Assurance Standards

The Auditing and Assurance Standards Board, in 2007, adopted the *Revised Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*. In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member, viz.,

SAs	• applies in the audit of historical financial information.
SREs	• applies in the review of historical financial information
SAEs	• applies in assurance engagements, dealing with subject matters other than historical financial information
SRSSs	• applies to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements

Further, there is also a mother standard on quality control. In addition, each of the above group of Standards has been allotted a numerical series as follows and the Standards pertaining to a particular group is allotted a number from that numerical series:

Type of Standard	Numerical Series
Standards on Quality Control (SQCs)	01-99
Standards on Auditing (SAs)	100-999
Standards on Review Engagements (SREs)	2000-2699
Standards on Assurance Engagements (SAEs)	3000-3699
Standards on Related Services (SRSSs)	4000-4699

The Standards on Auditing have also been further divided into seven categories

Based on the aspect of audit engagement addressed by them and each of these categories has a unique numerical series allotted. Therefore, a standard pertaining to a particular aspect of audit would be allotted a number from that relevant numerical series. These categories and series are as follows:

Aspect of Auditing Covered	Numerical Series
Introductory Matters	100 - 199
General Principles and Responsibilities	200 – 299
Risk Assessment and Response to Assessed Risk	300 - 499
Audit Evidence	500 – 599
Using Work of Others	600 - 699
Audit Conclusions and Reporting	700 - 799
Specialised Areas	800 - 899

The Council of the ICAI has issued following **Quality Control and Engagement Standards**

S.No	No. of Standard	Title of the Standard	Effective Date
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	April 1, 2009
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	April 1, 2010
3	SA 210	Agreeing the Terms of Audit Engagements	April 1, 2010
4	SA 220	Quality Control for an Audit of Financial Statements	April 1, 2010
5	SA 230	Audit Documentation	April 1, 2009
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements	April 1, 2009
7	SA 250	Consideration of Laws and Regulations in an Audit of Financial Statements	April 1, 2009
8	SA 260	Communication with Those Charged with Governance	April 1, 2009
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	April 1, 2010
10	SA 299	Responsibility of Joint Auditors	April 1, 1996
11	SA 300	Planning an Audit of Financial Statements	April 1, 2008
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	April 1, 2008
13	SA 320	Materiality in Planning and Performing an Audit	April 1, 2010
14	SA 330	The Auditor's Responses to Assessed Risks	April 1, 2008
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization	April 1, 2010
16	SA 450	Evaluation of Misstatements Identified During the Audits	April 1, 2010
17	SA 500	Audit Evidence	April 1, 2009
18	SA 501	Audit Evidence - Specific Considerations for Selected Items	April 1, 2010
19	SA 505	External Confirmations	April 1, 2010
20	SA 510	Initial Audit Engagements-Opening Balances	April 1, 2010
21	SA 520	Analytical Procedures	April 1, 2010

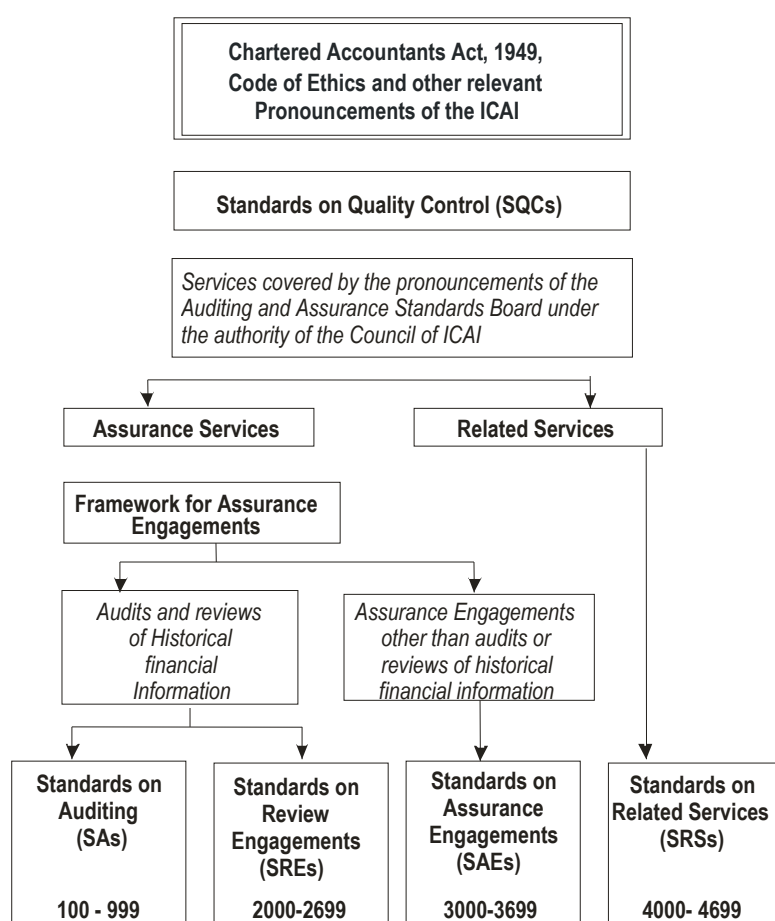
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22	SA 530	Audit Sampling	April 1, 2009
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	April 1, 2009
24	SA 550	Related Parties	April 1, 2010
25	SA 560	Subsequent Events	April 1, 2009
26	SA 570	Going Concern	April 1, 2009
27	SA 580	Written Representations	April 1, 2009
28	SA 600	Using the Work of Another Auditor	April 1, 2002
29	SA 610	Using the Work of Internal Auditors	April 1, 2010
30	SA 620	Using the Work of an Auditor's Expert	April 1, 2010
31	SA 700	Forming an Opinion and Reporting on Financial Statements	April 1, 2012
32	SA 705	Modifications to the Opinion in the Independent Auditor's Report	April 1, 2012
33	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	April 1, 2012
34	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements	April 1, 2011
35	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April 1, 2010
36	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks	April 1, 2011
37	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	April 1, 2011
38	SA 810	Engagements to Report on Summary Financial Statements	April 1, 2011
39	SRE 2400	Engagements to Review Financial Statements	April 1, 2010
40	SRE 2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity	April 1, 2010
41	SAE 3400	The Examination of Prospective Financial Information	April 1, 2007
42	SAE 3402	Assurance Reports on Controls At a Service Organisation	April 1, 2011

43	SRS 4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information	April 1, 2004
44	SRS 4410	Engagements to Compile Financial Information	April 1, 2004

A diagrammatic representation of the structure of Standards under the new Preface is given below:

Diagrammatic Representation of the Structure of Standards Under the New Preface



These Standards will apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon. While discharging their attest function, it will be the duty of members of the Institute to ensure that the Standards are followed in the audit of financial information covered by their audit reports. If for any

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reason a member has not been able to perform an audit in accordance with the Standards, his report should draw attention to the material departures therefrom, auditors will be expected to follow Standards in the audits commencing on or after the date specified in the statement. Remember all Standards are mandatory from the date mentioned herein and it is obligatory upon members of Institute to adhere to these whenever an audit is carried out.

All relevant Standards which are important from students' view point have been covered as an integral part of the text.

Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services: The Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services has been issued to facilitate understanding of the scope and authority of the pronouncements of the AASB issued under the authority of the Council of the Institute of Chartered Accountants of India (the ICAI).

The ICAI is committed to the goal of enabling the accountancy profession in India to provide services of high quality in the public interest and which are accepted worldwide. To further this goal, the ICAI develops and promulgates technical Standards and other professional literature. The ICAI being one of the founder members of the International Federation of Accountants (IFAC), the Standards developed and promulgated by the AASB under the authority of the Council of the ICAI are in conformity with the corresponding International Standards issued by the International Auditing and Assurance Standards Board (IAASB), established by the IFAC.

*The "Due Process" of the AASB for formulation of Standards, Statements, Guidance Notes and its other pronouncements is reproduced in the **Handbook on Auditing Pronouncements**.*

Compliance with Documents Issued by the Institute: The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters. The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

- (a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make **adequate disclosures in their audit reports** so that the users of financial statements may be aware of such deviations; and
- (b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the **material departures**, therefrom.

'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may rely in the course of their professional work and on which they may desire assistance in resolving issues which

may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are however a few guidance notes in case of which the Council has specifically stated (discussed in Announcements part reproduced in Handbook on Auditing Pronouncements) that they should be considered as mandatory on members while discharging their attest function.

1.4 The Auditor

The person conducting audit is known as the auditor; he makes a report to the person appointing him after due examination of the accounting records and the accounting statement in the form of an opinion on the financial statements. The opinion that he is called upon to express is whether the financial statement reflect a true and fair view. Auditing, especially of companies and for public purposes has become the preserve of persons having recognised professional training and qualification. In India, under the authority of the Companies Act, 2013, Chartered Accountants are professionally qualified for the audit of the accounts of companies.

1.4.1 Functional Classification of Auditors: Internal Auditor vs. External Auditor:

On the basis of functional division, auditors can be classified in two broad categories, namely, external auditors and internal auditors. External auditors are the persons who practise the profession of accountancy having qualified in the professional examination and are external *vis-a-vis* the organisation of which they audit the accounts. The internal auditors, on the other hand, may be professionally qualified or not and are internal *vis-a-vis* the organisation in which they are appointed to perform specific work. **It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.** The external auditors, on the other hand, are appointed by the owners of the organisation, say, shareholders of the company and thus they are treated external to the organisation in which they have been appointed. When an external auditor is appointed under a particular statute, such auditor may be known as the statutory auditor. Their scope of work is determined by the statute under which they have been appointed. Another significant distinction between the internal and external auditor is that the former is not considered independent *vis-a-vis* the management of the organisation while the latter is independent of the management of the organisation which is responsible for the preparation of the books of account. Finally the scope of work of an internal auditor may extend even beyond the financial accounting and may include cost investigation, inquiries relating to losses and wastages, production audit,

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performance audit, etc. It must be remembered that the basic foundation of any type of auditing, whether internal or external, envisages that the auditor must be independent of the activity for which he is going to conduct an audit. Even though the internal auditor is an employee yet he must be independent to the extent practicable.

1.4.2 Qualities of an Auditor: So far we have discussed the question of formal qualifications of an auditor. But it is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. **The Companies Act, 2013** and the Partnership Act, 1932 need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Lord Justice Lindley in the course of the judgment in the famous *London & General Bank* case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".

1.5 Objectives of Audit

1.5.1 Expression of opinion: *If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work. This principle was established as early as in 1896 in the leading case in Re-Kingston Cotton Mills Co.*

The nature of audit objectives was also highlighted in the leading case Re The London and General Bank Ltd. [1895]. It was held that an auditor must ascertain that the books of account show the true financial position of the company. For the first time, the duties of the company auditor were spelled out in specific terms. Lord Justice Lindley observed, "It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans without security. It is nothing to him whether the business of company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that."

As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and*
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.*

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion.

The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has

conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

So it follows from above that it is no part of the auditor's duty to probe into the propriety of business conduct. This contention has been held perfectly valid as it has been asserted that the conventional financial audit is concerned with examination of the transactions to ascertain the true and fair nature of the financial statements. The auditor is merely concerned with evaluating the evidence in support of transactions but need not examine the regularity and prudence of various decisions taken by the management.

However, of late, this has undergone a change as some of the requirements of law introduced in the past require the company auditor to go beyond the functions of reporting and express an opinion about the propriety or prudence of certain transactions in certain specific areas. Section 143 of the Companies Act, 2013 contain various such matters. It may also be clarified that the usage of words "true and fair" is restricted to certain countries such as U.K. while in other countries like United States the expression "full and fair" is prevalent. However both expressions aim to convey same meaning.

On a consideration of what has been discussed, it may be summed up that auditing has the principal objective of seeing whether or not the financial statements portray a true and fair state of affair and of reporting accordingly. An incidental and secondary, but by no means an insignificant audit objective, flowing from the former, is detection of errors and frauds and making recommendations to prevent their occurrence.

The term "Applicable financial reporting framework" is being explained here to have better understanding of this topic.

Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of

the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements.

1.5.2 Errors and Frauds: Accounting is a device for collecting and presenting useful information in financial terms about a business enterprise. It should as well be recognised that accounting data may contain errors for a variety of reasons, and those who rely on accounting data frequently have no way of determining for themselves the reliability of data presented. Even today the human element is the most significant element for recording and processing the accounting data. Human beings as they are always open to personal failures and allurements. The audit objective, in the past was, primarily concerned with the detection of errors and frauds and now, though the general audit engagement does not specifically require their detection, they do not rule them out and in fact stipulate their detection on the premise that no statements of account can be considered true and fair if substantial errors and frauds remain to distort the picture. Another presumption about errors and frauds which has wide recognition, is that the audit techniques and processes, if carried on conscientiously would bring to light errors and frauds even though the examination was not specifically directed to reveal them.

In the context of auditor's role in detection of frauds, a significant development in the sphere of management is the installation of control devices by the management to ensure compilation of reliable statements of account. These are designed to plug the possibilities of errors and frauds as they provide means for their early detection. It is true that management is responsible for prevention of errors and frauds. It can be argued that the auditor's role in their detection is very much conditioned by these developments. The auditor can achieve a lot by a purposeful review of those control systems and their operation. While conducting audit, the auditor may come to know the area where control is not foolproof or where control measures have not been properly operated with a view to ensuring better control over errors and frauds. In such instances, the auditor may provide the management with practicable suggestions for alteration or modification of the controls and checks. This is a safety for the future. It is a matter of safety for the business because by acting on the expert suggestions, a better assurance for obtaining reliable accounts is there. It is a safety for the auditor, if in future he is hauled up before the Court to defend a charge of negligence for non-detection of errors and frauds; it would be to his defense that he had already made the management aware of the weaknesses in the book-keeping system and procedures and the management had failed to act on his suggestions [Re S. P. Catterson & Sons Ltd.].

If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognised by the Courts as is obvious from a study of the various judgments. The auditor's performance is judicially viewed by applying the following tests:

- (a) whether the auditor has exercised reasonable care and skill in carrying out his work;
- (b) whether the errors and frauds were such as could have been detected in the ordinary course of checking without the aid of any special efforts;
- (c) whether the auditor had any reason to suspect the existence of the errors and frauds; and
- (d) whether the error or fraud was so deep laid that the same might not have been detected by the application of normal audit procedures.

We have so far discussed the general background and the position of the auditors as regards errors and frauds and we know that the auditor has a certain amount of responsibility for their detection.

We shall now analyse the causes and nature of errors and frauds. If an auditor is aware of these, detection becomes easier in the sense that he can direct his enquiry more objectively and plan his work having regard to general possibility of errors and frauds.

R.K. Mautz, in his book on "Fundamentals of Auditing" has classified the reasons and circumstances of errors and he has included fraud in the broad category of errors. The classifications are the following:

1. Ignorance on the part of employees of accounting developments, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.
2. Carelessness on the part of those doing the accounting work.
3. A desire to conceal the effect of defalcations of shortages of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever present desire to hold taxes on income to minimum.

A sixth cause may be added to those Mr. Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in position of authority to:

- (i) show up the picture depicted by the statements;
- (ii) depress the picture depicted by the statements; and
- (iii) convert the error to a personal benefit.

Errors and frauds both distort the true picture either by omission or by commission but the distinction between the two lies in intent. Error is an involuntary act whereas fraud is a

deliberate act. Mautz also has classified the types of errors. These are:

1. Self-revealing and not self-revealing
2. Unintentional and intentional
3. Unconcealed and concealed
4. Affecting general ledger balances and not affecting general ledger balances.

Self-revealing errors: These are such errors the existence of which becomes apparent in the process of compilation of accounts. A few illustrations of such errors are given hereunder, showing how they become apparent.

(i)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement.
(ii)	Wrong totaling of the Purchase Register.	Control Account (e.g., the Sundry Trade payables Account) balances and the aggregate of the balances in the personal ledger will disagree.
(iii)	A failure to record in the cash book amounts paid into or withdrawn from the bank	Bank reconciliation statement will show up error.
(iv)	A mistake in recording amount received from X in the account of Y.	Statements of account of parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

Many other errors, however, are not revealed by either of these possibilities. If an item of expense which should have been charged to repairs account has been charged by mistake to the building account or if the amount of depreciation is calculated incorrectly, there is nothing in the book-keeping system which will bring the error to notice. Such errors are non self-revealing errors.

Suppose a debit entry is omitted to be posted in the ledger and there are one or more of such omissions of credit entries which exactly compensate the effect of the former omission, then another self-revealing error turns to be not so. Such mistakes may remain undetected indefinitely unless measures aimed at discovering such errors are applied.

Intentional Errors or Frauds: Fraud is the word used to mean intentional error. This is done deliberately which implies that there is intent to deceive, to mislead or at least to conceal the truth. It follows that other things being equal, they are more serious than unintentional errors because of the implication of dishonesty which accompanies them.

As per SA-240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- *Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.*
- *A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.*

Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity’s performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax

or to inflate earnings to secure bank financing.

3. *Fraudulent financial reporting may be accomplished by the following:*

- *Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.*
- *Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.*

Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

4. *Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:*

- *Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.*
- *Inappropriately adjusting assumptions and changing judgments used to estimate account balances.*
- *Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.*
- *Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.*
- *Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.*

Altering records and terms related to significant and unusual transactions.

5. *Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:*

- *Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).*
- *Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).*
- *Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).*
- *Using an entity's assets for personal use (for example, using the entity's assets as*

collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

6. *The auditor may, at times, be required to by a legislation or a regulation to make a specific assertion in respect of frauds on/by the entity in his report. For example, Section 143(12) of the Companies Act, 2013 requires that, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner prescribed in rule 13.*

Also, Clause (xii) of Paragraph 3 of the Companies (Auditor's Report) Order, 2015 requires the auditor to specifically report "whether any fraud on or by the company has been noticed or reported during the year ; If yes, the nature and amount involved is to be indicated".

Similarly, in case of audit of banks, the auditors, in terms of the circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02, is required to report to the Reserve Bank of India anything susceptible to fraud or fraudulent activity or act of excess power or any foul play in any transaction. Consequently, in such cases, the auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

Therefore, it is clear from the above that the 'fraud' deals with intentional misrepresentation but, 'error', on the other hand, refers to unintentional mistakes in financial information.

Intentional errors are most difficult to detect and auditors generally devote greater attention to this type because out of long and sometimes unfortunate experience, auditors have developed a point of view that if they direct their procedures of discovering the more difficult intentional errors, they are reasonably certain to locate the more simple and far more common unintentional errors on the way. The auditors have also learnt by experience that although most people are honest under different circumstances but they may be unable to resist temptations. When circumstances are such that the possibility of being caught is rather remote, most people are likely to respond to temptation. This is a well known aspect of human behaviour. Auditors while studying the possibility and nature of fraud, must keep this always in mind and should not make any exception for those who held high offices. Factors, like job satisfaction in terms of responsibility, trust and reward, personal habits, temporary requirements etc., have great bearing on the matter of commission of fraud. These things generally start in a non-consequential way-often a subordinate staff member first borrows small amounts from the cash box to meet his temporary difficulty and then gradually it becomes his habit to borrow in such manner whenever he is in difficulty; when he finds that nobody has even an inkling of the matter, he ventures with far larger amounts which on many

occasions, he finds himself unable to replace. Fraud also takes place in forms other than cash defalcation, discussed above. It may be misappropriation of goods or manipulation of accounts with a view to presenting a false state of affairs.

Defalcation of Cash: Defalcation of cash has been found to perpetrate generally in the following ways:

(a) By inflating cash payments.

Examples of inflation of payments:

- (1) Making payments against fictitious vouchers.
- (2) Making payments against vouchers, the amounts whereof have been inflated.
- (3) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
- (4) Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(b) By suppressing cash receipts. Few Techniques of how receipts are suppressed are:

- (1) *Teeming and Lading*: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.
- (2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.
- (3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
- (4) Not accounting for cash sales fully.
- (5) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.
- (6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(c) By casting wrong totals in the cash book.

Misappropriation of Goods: Fraud in the form of *misappropriation of goods* is still more difficult to detect; for this management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In

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addition there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationery. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists. For example, the gross profit ratio adjusted for any recorded change during the year, reveals whether the value of inventory is reasonable with reference to the amount of the sale. Similarly, the input-output ratio of production in terms of physical quantity may reveal whether output is normal with reference to the quantity consumed for production.

Manipulation of Accounts: Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

- (a) to avoid incidence of income-tax or other taxes;
- (b) for declaring a dividend when there are insufficient profits;
- (c) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and
- (d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

There are numerous ways of committing this type of fraud. Some of the methods are given below:

- (i) inflating or suppressing purchases and expenses;
- (ii) inflating or suppressing sales and other items of income,
- (iii) inflating or deflating the value of closing inventory;
- (iv) failing to adjust outstanding liabilities or prepaid expenses; and
- (v) charging items of capital expenditure to revenue or by capitalising revenue expenses.

Concealed and Unconcealed Errors: As a general rule, mistakes are unconcealed but frauds are deliberately concealed. This proposition does not need any elaboration; but exceptions are in both cases. Mistakes become concealed if compensated by another or more mistakes in the opposite direction; or it may even be greatly minimised by that chance happening. For example, by mistake one or more accounts were short debited by an aggregate figure of ₹ 30,000 and this short debit is compensated by chance error or say short casting or one or more credit accounts to the tune of say ₹ 30,200 the dimension of the error would apparently be ₹ 200 by which the trial balance would be thrown out of agreement and

there may be a temptation to think, "the error is small, let us ignore it". This attitude towards apparently small errors is dangerous because its true dimensions remain concealed and that may render the statements of account totally unacceptable. Mistakes may as well be concealed for wrong arithmetical calculations or for a faulty process of verification. Depreciation and inventories are examples which immediately come to one's mind. Wrong calculation of depreciation or omission to include certain inventories in the inventory or wrong valuation of inventories is not apparent. Petty cash defalcation is often unconcealed because petty cash is an item which on many occasions is left out of checking.

Procedural Errors: Sometimes we become so obsessed with the general ledger and its supporting records that we neglect other important features of the accounting system. An accounting system includes both records and procedure. Errors can appear in either or both. Whatever errors occur in the implementation of the procedures may be termed as procedural errors (which include frauds also). For example, the sales procedure of a company may include the following steps:

- (a) Receipt of an order through salesman.
- (b) Review of order by the credit department to determine whether the customer should be given credit as requested.
- (c) Clearance with inventory department to be sure that the order can be executed.
- (d) Preparation of forwarding note with copies to obtain the customer's acknowledgement of the receipt of goods.
- (e) Preparation of invoice and despatch of the same to the customer.

If the procedure requires that these steps should be taken in the order indicated and if, for any reason, the second step is omitted, or is not completed before subsequent steps have been taken an error in procedure has been made and this may lead the company into financial loss caused by non-recovery of the money. Procedures are established to maintain control over resources and over transactions; any failure to follow the established procedures lessens the control and may permit errors which do affect ledger accounts. Any breakdown in established procedures thus suggests not only the presence of a procedure type error but also of other consequences.

Other errors of this type include the approving of transactions of documents by someone other than the person authorised to do so, failure to ensure that all preceding steps have been taken before approving a document and substitution of one person by another in a procedural function without proper authority. It is the normal procedure that goods, when received should be inspected for quality by the inspection department staff. If the store-keeper carried out this function it is indeed risky. Similarly, if the procedure requires that the timber godown should have been given periodical insecticide treatment and management has ignored that, a great loss may be caused to the timber by white ants. What is needed to be emphasised here is this that a procedural error, which is neither a defalcation nor misappropriation, may involve the company in a sizeable loss. This type of error or fraud cannot be located by any rigorous

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examination of the books of account.

All these errors discussed above may be grouped in the following categories in terms of their accounting incidence:

- (i) Errors of omission - where a transaction has been omitted either wholly or partially.
- (ii) Errors of commission - where a transaction has been mis-recorded either wholly or partially.
- (iii) Compensating errors - where there are two or more errors which exactly counter balance each other, so that the trial balance agrees in spite of them.
- (iv) Errors of principle - these are errors arising as a result of transactions having been recorded in a fundamentally incorrect manner; for example, a distinction not being made between capital and revenue income or expenditure.
- (v) Procedural errors.

1.5.3 Detection of Fraud and Error - Duty of an Auditor: As per SA-240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", states that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability. *Broadly, the general principles laid down in the SA may be noted as under:*

1. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA 200, **"Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing,"** owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.
2. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when

accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

3. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.
4. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

SA-240, further explains by way of example lists certain risk factors and circumstances relating to possibility of fraud which may be considered by the auditor are dealt in the following paragraphs. *Fraud risk factors* may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

I Examples of Fraud Risk Factors: The fraud risk factors identified here are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting: The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting -

Incentives/Pressures: Financial stability or profitability is threatened by economic, industry,

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or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant trade payables, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, inventory options, and earn-out arrangements) being contingent upon achieving aggressive targets for inventory price, operating results, financial position, or cash flow.
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities: The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

Attitudes/Rationalizations: Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.

- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's inventory price or earnings trend.
- The practice by management of committing to analysts, trade payables, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
 - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets: Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors

related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures: Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities: Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.

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- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations: Disregard for the need for monitoring or reducing risks related to misappropriations of assets.

- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

II. Examples of circumstances that indicate the possibility of fraud: The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.

- Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled cheques in circumstances where cancelled cheques are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's Code of Conduct.

1.6 Basic Principles Governing an Audit

Presently there is no specific standard namely basic principles governing an audit. But there are certain basic principle which governs the auditor's professional responsibilities and should be complied with whenever an audit is carried out. Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. The basic principles as stated in this guideline are:

1. **Integrity, objectivity and independence:** The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.
2. **Confidentiality:** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.
3. **Skills and competence:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence which are acquired through a combination of general education, knowledge obtained through study and formal courses concluded by qualifying examination recognised for this purpose and practical experience under proper supervision. In addition, the auditor requires a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.
4. **Work performed by others:** When the auditor delegates work to assistants or uses work performed by other auditors and experts he continues to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, as in the case of the work of branch auditors appointed under the Companies Act, 2013 the auditor's report should expressly state the fact of such reliance. The auditor should carefully direct, supervise and review work delegated to assistants.

The auditor should obtain reasonable assurance that work performed by other auditor or experts is adequate for his purpose.

5. **Documentation:** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.
6. **Planning:** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business. Plans should be made to cover, among other things:
 - (a) acquiring knowledge of the client's accounting system, policies and internal control procedures;
 - (b) establishing the expected degree of reliance to be placed on internal control;
 - (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
 - (d) Coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

7. **Audit Evidence:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions there from on which to base his opinion on the financial information. *Compliance procedures* are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. *Substantive procedures* are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

They are of two types:

- (i) test of details of transactions and balances; and
 - (ii) analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.
8. **Accounting System and Internal Control:** Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the auditor concludes that he can rely on certain internal controls, his substantive

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procedures would normally be less extensive than would otherwise be required and may also differ as to their nature and timing.

9. **Audit conclusions and reporting:** The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. This review and assessment involves forming an overall conclusion as to whether :
- (a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
 - (b) the financial information complies with relevant regulations and statutory requirements;
 - (c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

The audit report should contain a clear written opinion on the financial information and if the form or content of the report is laid down in or prescribed under any agreement or statute or regulation, the audit report should comply with such requirements. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters stated above or as may be laid down or prescribed under the agreement or statute or regulation as the case may be.

When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefore.

Note: Student may note that at present, there is no specific standard namely basic principles governing an audit. However, there are certain fundamental principles which are ethically required as per Code of Ethics read with SA 200 (Revised) and SA 220. But in general above mentioned principles are basic principles only.

1.7 Scope of Audit

The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

The audit should be organized to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements being audited. To form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for the preparation of the financial statements. In forming his opinion, the auditor should also decide whether the relevant information is properly disclosed in the financial statements

subject to statutory requirements, where applicable. The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:

- (a) making a study and evaluation of accounting systems and internal controls on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures; and
- (b) carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

The auditor determines whether the relevant information is properly disclosed in the financial statements by :

- (a) comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarize the transactions and events recorded therein; and
- (b) considering the judgments that management has made in preparing the financial statements accordingly, the auditor assess the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operation results of the enterprise. The auditor recognizes that because of the test nature and other inherent limitations of an audit together with inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatements may remain undiscovered. While in many situations the discovery of material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions.

The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. However, it is difficult to lay down any definite standard by which materiality can be judged. Material items are those which might influence the decisions of the user of the financial statements. It is a matter in which a decision is arrived at on the basis of the auditor's professional experience and judgment.

The auditor is not expected to perform duties which fall outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statement should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion.

The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

Aspects to Be Covered In Audit: The principal aspect to be covered in an audit concerning final statements of account are the following:

- (i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.
- (ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
- (iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
- (iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

- (v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
- (vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
- (vii) Verification of the title, existence and value of the assets appearing in the balance sheet.
- (viii) Verification of the liabilities stated in the balance sheet.
- (ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
- (x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
- (xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

It will thus be realised that the duties are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

1.8 Inherent Limitations of Audit

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing",

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- (i) **The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of

uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. ***For example, this is often the case with respect to certain accounting estimates. Nevertheless, the SAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.***

- (ii) **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:
 - 1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. ***Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.***
 - 2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. ***Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not.*** The auditor is neither trained as nor expected to be an expert in the authentication of documents.
 - 3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.
- (iii) **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** ***The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.*** There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.
- (iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect

material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. ***Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.***

1.9 Auditing And Investigation

To understand auditing in its correct perspective, one should know how auditing is distinct from investigation.

Auditing is different from investigation which is another significant service, a professional accountant renders. Investigation is a critical examination of the accounts with a special purpose. For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, e.g., the extent of waste and loss, profitability, cost of production, etc. It normally concerns only specified areas, but at times, it may involve the whole field of accounting. Its essence lies in going into the matter with some pre-conceived notion suited to the objective. The techniques fit the circumstances of the case. For auditing on the other hand, the general objective is to find out whether the accounts show a true and fair view.

Audit never undertakes discovery of specific happenings and is never started with a pre-conceived notion about the state of affairs. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe: fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the *prima facie* findings of the auditor. However, as per sub section

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12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner prescribed in rule 13.

Rules 13 of the Companies (Audit and Auditors) Rules, 2014, prescribes that in case the auditor has sufficient reason to believe that an offence involving fraud, is being or has been committed against the company by officers or employees of the company, he shall report the matter to the Central Government immediately but not later than sixty days of his knowledge and after following the procedure indicated herein below:

- (i) auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within forty-five days;
- (ii) on receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the Audit Committee alongwith his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days of receipt of such reply or observations;
- (iii) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government alongwith a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time.

Further, the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same. This report shall be on the letter-head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and shall indicate his Membership Number. The report shall be in the form of a statement as specified in Form ADT-4.

No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that the provision of this rule shall also apply, *mutatis mutandis*, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

1.10 Types of Audit

Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories *i.e.*, audit required under law and voluntary

audits.

- (i) Audit required under law: The organisations which require audit under law are the following:
 - (a) companies governed by the Companies Act, 2013;
 - (b) banking companies governed by the Banking Regulation Act, 1949;
 - (c) electricity supply companies governed by the Electricity Supply Act, 1948;
 - (d) co-operative societies registered under the Co-operative Societies Act, 1912;
 - (e) public and charitable trusts registered under various Religious and Endowment Acts;
 - (g) corporations set up under an Act of Parliament or State Legislature such as the Life Insurance Corporation of India.
 - (h) Specified entities under various sections of the Income-tax Act, 1961.
- (ii) In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. In respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited. Government companies have some special features which will be seen later.

As already stated, the auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. Also it is always a wise precaution to state in the report, accompanying the balance sheets of proprietary or partnership firms or other similar organisations, the nature of the work carried out and explain the important features of the financial statements on which a report has been made. Furthermore, to ensure that the report will be brought to the notice of all concerned, the accounts should bear reference to the report.

A special reference is necessary for non-profit making institutions like schools, clubs, hospitals. Most of these have some internal rules to govern their affairs and generally a provision about the requirement of audit is inserted. Activity in the nature of business is not altogether ruled out as a club may sell drinks and eatables to the members and their guests or a school may have endowed agricultural property to yield income. What makes them distinct, is the absence of the question of division of profit : any surplus which may arise can only be used for achieving the objects of the institution. Educational institutions, hospitals, associations, etc., irrespective of any internal rules, get their accounts audited because most of them enjoy government or municipal grants and, generally, for this purpose audited accounts are insisted upon.

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Trust, however, stands on a slightly different footing; these may be public trusts or private trusts. Trusts can carry on business as well. In the majority of cases trustees are private persons. Trusts generally have two classes of beneficiaries; tenants for life and remainders; persons to whom the accounts are of the supreme importance are often widows and minors, who cannot criticize the accounts in any effective manner. Though audit of trusts, except for public trusts, is not compulsory most of the trust deeds contain a clause for audit of accounts. Private trustees also recognise the advantages of audit in their own interest, since any erroneous treatment in the accounts for which they might be personally liable will be pointed out by the auditor.

1.11 Advantages of an Independent Audit

The fact that audit is compulsory by law, in certain cases by itself should show that there must be some positive utility in it. The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

- (a) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.
- (b) It acts as a moral check on the employees from committing defalcations or embezzlement.
- (c) Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.
- (d) These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.
- (e) An audit can also help in the detection of wastages and losses to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.
- (g) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.
- (h) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.
- (i) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.
- (j) Government may require audited and certified statement before it gives assistance or issues a license for a particular trade.

1.12 Relationship of Auditing With Other Disciplines

The field of auditing as a discipline in simple words involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

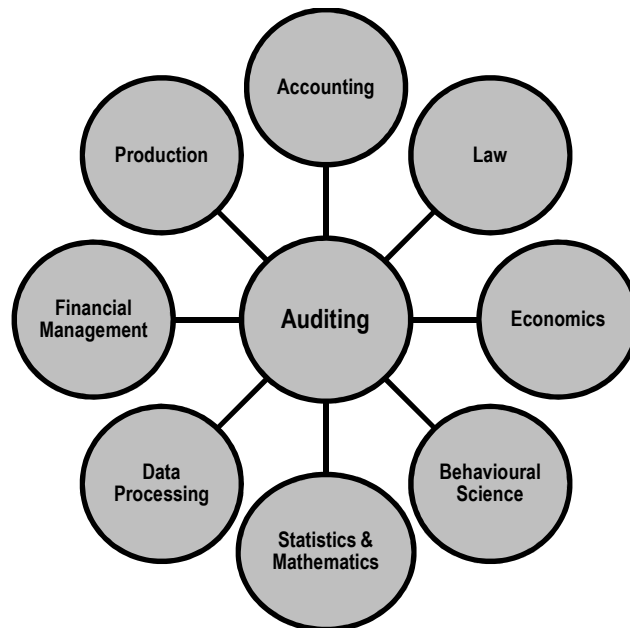


Diagram showing the relationship of Auditing with other Disciplines

1.12.1 Auditing and Accounting: It has been pointed out earlier that both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the foundations on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

1.12.2 Auditing and Law: The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good

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knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

1.12.3 Auditing and Economics: As, it is well known, accounting is concerned with the accumulation and presentation of data relating to economic activity. Though the concept of income as put forward by economists is different as compared to the accountants concept of income, still, there are lot of similar grounds on which the accounting has flourished. From the auditing view point, the auditors are more concerned with Micro economics rather than with the Macro economics. The knowledge of Macro economics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and Government regulations. Auditor is expected to be familiar with the overall economic environment in which his client is operating.

1.12.4 Auditing and Behavioural Science: The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. However, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

1.12.5 Auditing and Statistics & Mathematics: With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures. With the emergence of test check procedure, discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.

1.12.6 Auditing and Data Processing: Today, organisations are witnessing revolution in the field of data processing of accounts. Many organisations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed. The

dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy. With such a phenomenal growth in the field of computer sciences, the auditor should have good knowledge of the components, general capability of the system and the related terms. In fact, EDP auditing in itself is developing as a discipline in itself.

1.12.7 Auditing and Financial Management: Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel and other general areas of business management. With the overgrowing field of auditing, the financial services sector occupies a dominant place in our system. While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place. The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.

1.12.8 Auditing and Production: Regarding production function, it may be stated that a good auditor is one who understands the client and his business. While carrying out the audit activity, the auditor is required to evaluate transactions from the accounting aspect in relation to the process through which it has passed through as accounting for by-products; joint-products may also require to be done. The knowledge of production process shall become more essential in case of an internal auditor. The auditor shall also require understanding the cost system in operation in the factory and assessing whether the same is adequate for the particular company. The understanding of the terminology of the production shall enable an auditor to communicate with production employees in connection with his work.

On the similar pattern the auditor is also expected to have good understanding about the marketing, personnel and other general business management areas.

Case study

Mr. Veeru of Delhi has started a new business of selling of Handloom items. He purchases these items from a factory situated in Ludhiana and sells to local customers at a price which gives him reasonable amount of profit. All gets well in the first year and he earns some income from the business.

However, he feels that he could expand this business if he was able to bring more items to the place where he sells them and also he is aware of the fact that there are several other locations as well where he could sell these items. He could achieve this by buying a van and by employing other people who will assist him in his business on the other locations.

He needs more money to achieve this expansion of his business. He decides to ask his friend Raju to invest in the business.

Having seen the potential of Veeru's business, Raju wants to invest, but neither he wants to manage nor wants to have ultimate liability for the debts of the business in case business fails.

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He therefore suggested that they should set up a proprietary firm. He will be the owner of the firm and will be entitled to profits. On the other hand, Veeru would be the Manager and be paid a salary.

At the end of the first year of trading when Raju receives copy of the financial statements, he finds that Profits are much lower than what was expected. Raju knows that Veeru is paid salary so he may not care for low profits. Raju is concerned by the level of profits and feels that he wants further assurance on the accounts. He does not know whether the accounts give a true and fair view of the last year's trading because the profits do not seem as high as those Veeru had predicted when he agreed to invest.

Raju seeks solution for his problem.

The solution is that the assurance Raju is seeking may be given by an Independent Audit of accounts.